DOW THEORY LETTERS INC.

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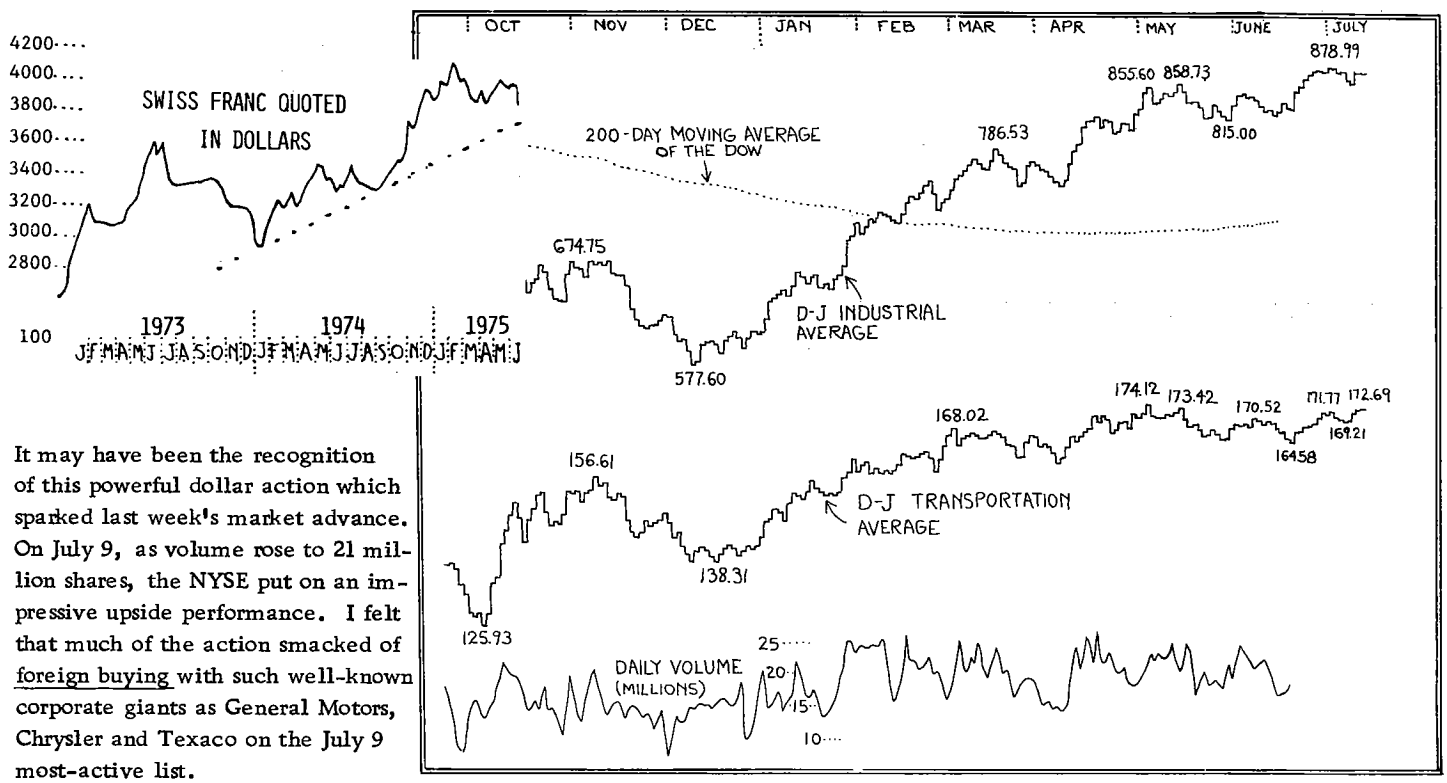
July 3, DJIA 871.79; PTI 397; A-D ratio -27.73
July 11, DJIA 871.09; PTI 407(new high); A-D ratio -25.19 (new high)

THE PICTURE: I'm starting this Letter with an orthodox Dow Theory discussion because at this juncture the story is in the Averages. Since May 5, 1975, the Averages have been stalling, backing and filling, resisting confirmation and otherwise biding their time. Something has been worrying this market, but that something has not been enough to send the Averages to significantly lower levels. At the same time, the picture ahead has not been clear enough to propel the two Averages to new highs (see chart on this page). Thus the Averages have delivered a frustrating series of upside and downside non-confirmations, all the while holding (since May) within a rather narrow range.

True, the market has a number of things to worry about. For instance, it could worry about why the aluminum companies want a price increase when they are operating at only 75% capacity. The same applies to the price increases being asked by the auto firms. Is there a profit squeeze that is continuing even as business seems ready to expand and even after most firms have moved to slash costs drastically? Or has the market been worried about an underlying inflation that could flare up at the first sign of a real business upturn? Or does the market sense that the consumer (despite tax rebates and handouts) is still weighed down by expenses and inadequate income, the twin phenomena which could put the brakes on any recovery?

The possibilities and combinations are fascinating and endless. But so are the bullish possibilities. For instance, in the last Letter I drew attention to the dramatic reversal in the dollar, the pushing up of the trade-weighted dollar above a six-year declining trendline. This action, I said, could bring in a huge influx of foreign buying in all categories of US investments. In fact, for many months I have received reports from European correspondents to the effect that they were ready to move into Wall Street as soon as they were convinced that the dollar had hit bottom and was moving higher.

Well, it's finally happening. By last week the dollar had risen almost 5% above its 1975 low (measured against 14 other currencies). As the chart shows, the Swiss franc (which has been climbing for almost three years against the dollar) has now fallen back to the 3900 level. A breaking of this level could send the Swiss franc under its two-year rising trendline (measured against the dollar, of course).



It may have been the recognition of this powerful dollar action which sparked last week's market advance. On July 9, as volume rose to 21 million shares, the NYSE put on an impressive upside performance. I felt that much of the action smacked of foreign buying with such well-known corporate giants as General Motors, Chrysler and Texaco on the July 9 most-active list.

The July 9 advance took the D-J Industrials to 871.87, 8 points from

its June 30 high for the year. But more important, the Transportation Average closed the day at 172.03, thereby bettering its two preceding peaks of 170.52 (June 6) and 171.77 (July 1). The July 9 rally put Transports within 2 points of the critical 1975 Transports high of 174.12 (see the page 1 chart). July 10 proved a teasing day for Wall Street, with Industrials up over 6 points at one time and Transports rallying intra-day above their 172.12 May 5 high. But Dow's Theory goes on closing prices, and when the day ended and the traders and speculators had cleared their accounts, it was a disappointment. Industrials closed virtually even while Transports were up only .45. July 11 (Friday) provided more of the same. The market was up all day, only to fade at the close with Industrials off .78 and Transports up .21. As has been the case for the past two months, the Averages are showing great reluctance to provide an all clear signal. Such a signal would entail a rally by both Averages to new recovery highs (see end of Letter for the latest on the price movement).

DOW'S THEORY: There never was a technical indicator that didn't fade into oblivion or lose popularity at one time or another. Most of the indicators enjoy a kind of analysts' fad for a few years, based on "past studies" of their usefulness in calling market turns. The more impressive the past history, the bigger the following once the new indicator is presented to the public. Then the following builds up, and a strange phenomenon occurs. Wall Street begins to discount the indicator, to jump the gun on it, and suddenly the indicator doesn't work any more. I've seen them come and I've seen them go. But I've never seen an individual indicator last in popularity more than five years or so.

One system which has survived the test of time is Dow's Theory, and the reason the Theory has lasted is that it is really not a system at all. Dow's Theory won't show you how to "beat the market," it won't (in itself) make you rich, it won't allow you to sleep peacefully with a fat portfolio during the life of a bull market. But Dow's Theory does provide a very useful body of market knowledge that has withstood the test of time. For 75 years men have learned and benefitted from the Theory, and only during one span (between 1940 and 1955) was there a real dearth of interest in the Theory.

Today, the Dow Theory is more useful than ever simply because we have more history to go on, more examples, more knowledge of what happens when "this Average does that" or when "volume expands and the Averages break there." Whenever the market moves into a "hard place," whenever I find myself scratching my head because the Averages seem so puzzling, I turn to Dow's Theory in an attempt to make sense out of what I see.

I'll let you in on a secret. There never was (nor will there ever be) an easy bull market or a snap bear market. The stock market may best be viewed as your enemy. It is out to make a fool of you, it is out to part you from your bankroll; it is intent on using your emotions against you. And it often succeeds beautifully in its efforts.

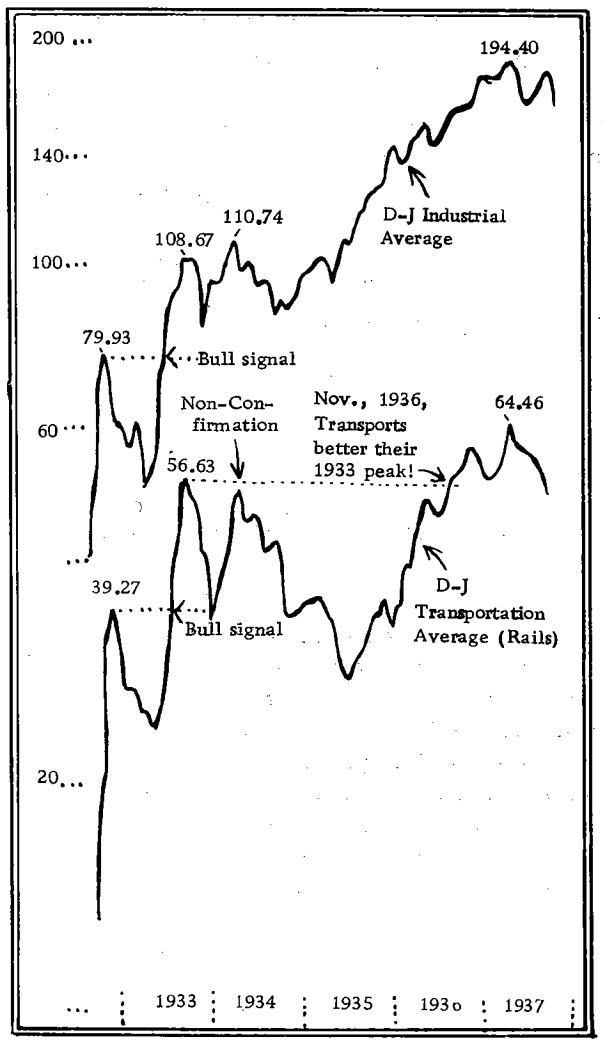
This primary bull market has been hard to believe in many ways and in others it has been strikingly logical. During October to January we saw the informed buying, the buying by the large individual investors, the value-wise market practitioners who have the purchasing power and the strength-of-conviction to turn the tide.

Around January the funds and institutions began to understand the picture. Once the big individual investors do their buying, they are willing enough to have cocktails with the fund and institutional boys. So the Wall Street rumor, gossip and "inside info" mills lit up like a Christmas tree around the turn of the year ("I tell you, Flagenheimer has loaded up with half a million shares of US Steel. He showed me the slips!").

Somewhere around March or April I would say the better informed public began picking up shares, and it was here that the Boardrooms started to fill up as the later arrivals stood around watching their purchases bob with the tide.

Now comes July, the booming dollar, and the entrance of the big foreign money. "They're coming, the Swiss are coming, the Arabs are coming!" I can't tell you exactly which Arab sheik or German bank is swapping currency for stock certificates, but it's happening, and my guess is that it started around early July.

What's left? The public is left, the odd lot public and the "cat-and-dog" public and the low-priced "ready for a big upward pop" public. They're primed for action, and it wouldn't surprise me to see them arrive on the scene at any moment.



Many commentators and analysts are still saying that this bull market is a fake, it's a bear market rally, it's a trap. I have not gone along with that line of reasonsing. Nor do I go along with those who say that this market is fated (following the exhaustion of the current upside momentum) to crash to new lows — below the 1974 lows.

I have on a number of occasions compared this market to the unique bull market of 1937, and at this point, I think it would be constructive to recount the story of 1932-37 from the standpoint of the Averages and the many extraordinary non-confirmations. The following may also demonstrate the danger in attempting to prove that the Dow Theory bull signal of January 27, 1975, was a false signal or a mistake.

One point I would like subscribers to remember is that once Dow's Theory has signalled a new primary bull market, that signal cannot be rescinded unless the Averages trace out a new bear signal (and I would have to ponder if that kind of aberration now developed) or unless both Averages turned down and sunk below the old bear market lows (and if that happened I would say that we had been in a bear market upward correction all along, rather than a new bull market).

This is the story of the hugely profitable and very trying 1932-37 primary bull market (which came following history worst stock market crash-collapse). The first bull swing (see page 2 chart) from the 1932 bottom took Industrials to 79.93, Transports to 39.27 (see chart). A violent correction carried into February of 1933 with both Averages holding above their 1932 lows. At that point, it was recognized (at least by Robert Rhea) that any advance which took the two Averages above their 1932 rally peaks would signal a new bull market.

The advance started in late-February. The two Averages bettered the 1932 peaks during May, and a new primary bull market was signalled under Dow Theory. The advance continued to July with Industrials topping at 108.67, Transports peaking at 56.53. Another violent correction occurred, and the decline continued into October, 1933. A new advance started, and by February, 1934, Industrials recorded a bull market high of 110.74. Transports, however, refused to better their 1933 high of 56.53. Down went the market again, and it must have been very scary, as Dow Theorists studied the Averages and realized that Transports (even in late-1934) had never bettered their 56.53 high of July 7, 1933.

The market turned up in 1935, and again the Industrials plowed ahead. By April of 1935 Industrials had rallied to a new bull market high, but still Transports refused to better the 1933 peak! The year 1935 passed into history, and 1936 saw a continuation of the rally. During July, 1936 Industrials hurdled the 160 level, their highest point of the bull market. July saw Transports struggling at 55, still under the 1933 peak.

Robert Rhea wrote that there was no time limit on the confirmation principle, and although he conceded that the 1933-36 period presented a most extraordinary situation, he also stated that in time the Transports would confirm. He added, however, that the longer the time lapse prior to confirmation, the less the meaning of the ultimate confirmation. When Transports finally do confirm, Rhea wrote, the bull market could be almost over.

Then the miracle occurred. In November of 1936, more than three years after their 1933 peak, Transports confirmed. The confirmation pleased Rhea but hardly excited him. True to his prediction, the 1932-37 bull market topped out four months after the Transport confirmation — in March, 1937. And students of Dow's Theory were left with a remarkable history of the relationship of the Averages during a most difficult bull market. What saved Rhea? Only his intuition and his fundamental understanding of the primary trend. (I refer to the Transports in this piece, but of course they were the Rails in the 1930's).

MOST-ACTIVES: I have stated in recent Letters that during a bull movement the place to watch is in the area of the strongest indicator. As a rule, as long as this special "pocket of strength" holds, the market momentum will continue upwards. But when the strongest indicator finally goes, then "watch out." The backbone of the bull movement has probably snapped.

In Letters 632 and 634 I drew particular attention the cumulative most active stock index (CMAS). The 15 daily most active stocks on the NYSE usually account for 15% to 30% of total volume. These most actives are where the real action is, where the big accumulation is, or where the big distribution is. I take the plurality of the most actives each day, and use that plurality as an advance-decline index. Each day's plurality is added or subtracted (as the case may be) to the preceding day's figure, and this continuing index is what I show on the accompanying chart (see page 4).

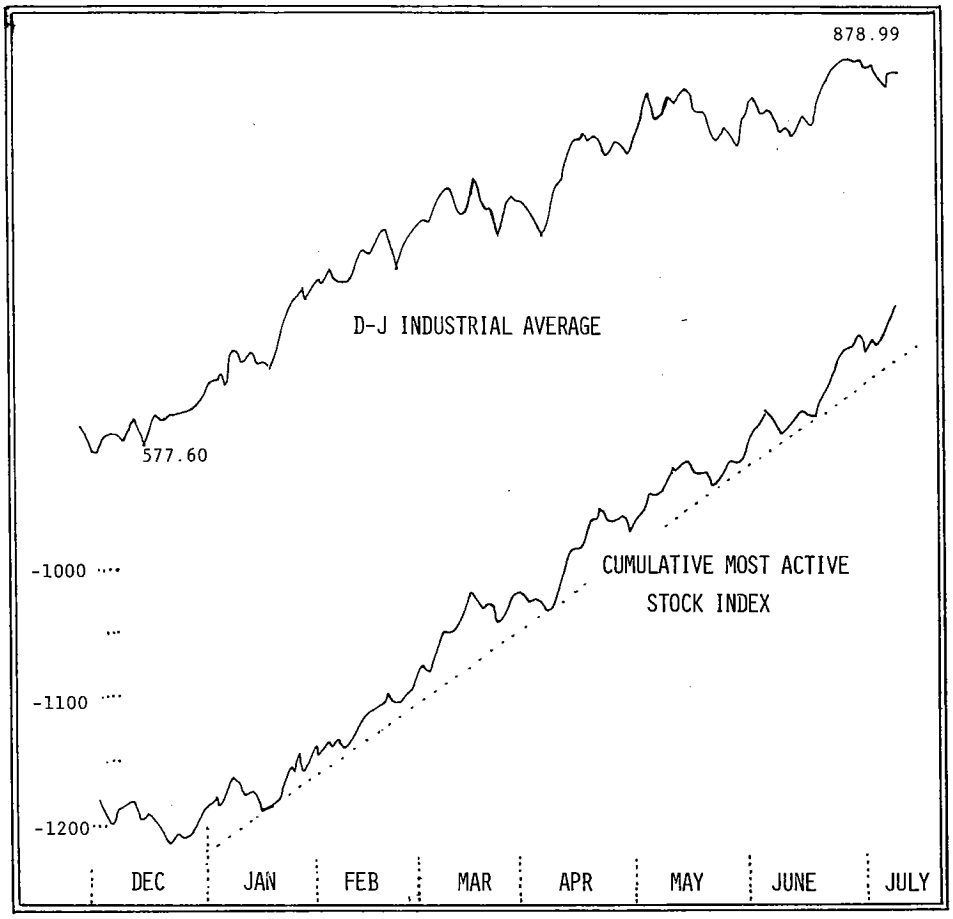
To make a longish story short, the CMAS has held intact in a perfect rising trend ever since December, 1974. The ascending trendline, as seen on the chart, has been tested (touched) by the index four times since December. Each time the index has bounced higher. The fact is that there has been very little let-up in accumulation among the most-actives over the past eight months.

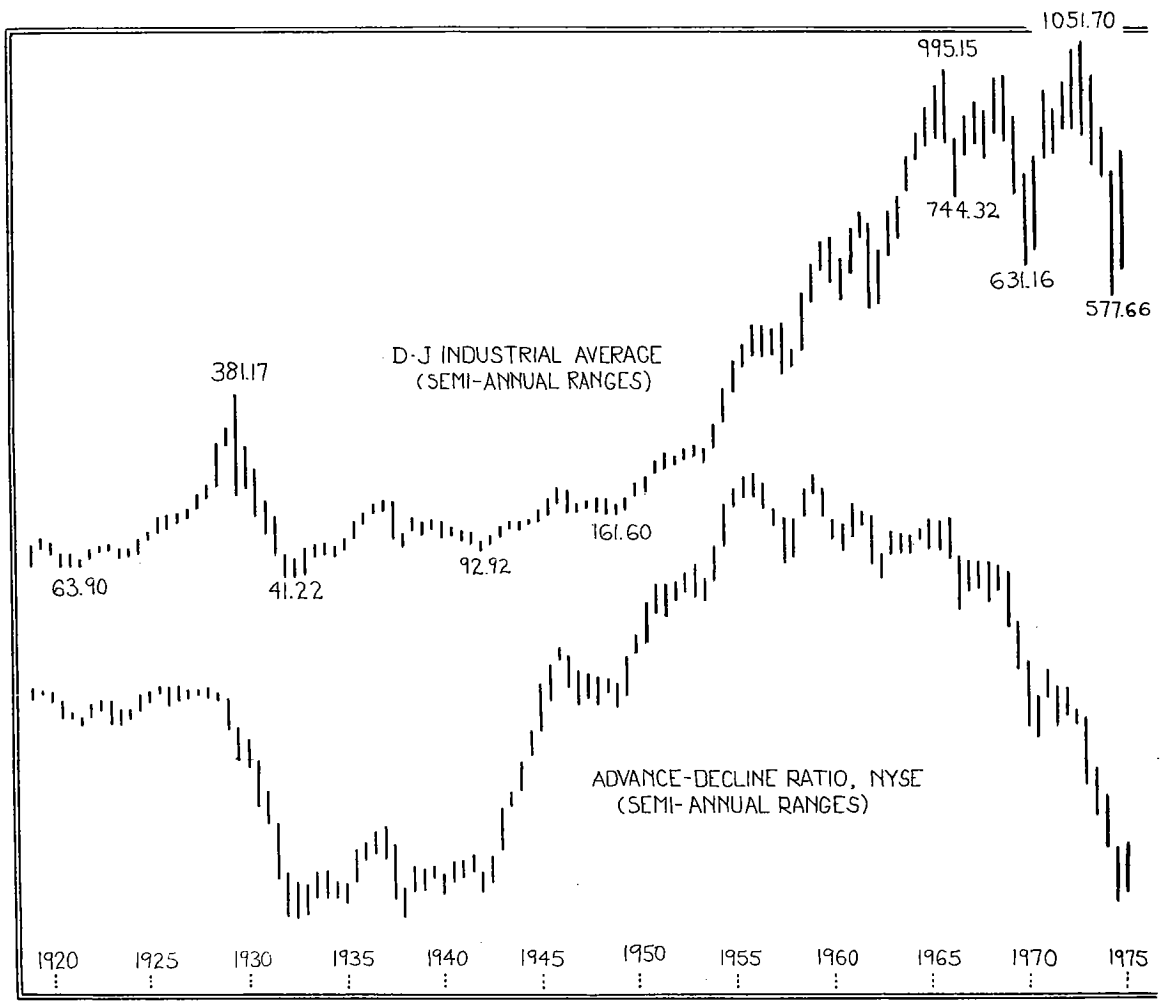
Ultimately, we are going to see the eight month trend of most actives turn down, then break the trendline. When that happens we will know that the big money is moving out of this market on a trend basis. I would guess that such action will mark the end of this second leg in the bull market.

THE DOW AND BREADTH: Below is my chart of the Dow and the advance-decline ratio going back to 1919. Each vertical bar represents a six month high-low range, which means that there are two bars for each full year. The chart allows us to study the broad sweep of history, going back over half a century.

Basically, what I want to show here is the relative action of the Dow and the advance-decline ratio. History shows that there tends to be a harmonious relationship between breadth (A-D ratio) and price (the Dow). When any movement results in divergence or non-confirmations between the price and breadth, the market comes under strain. Ultimately, such abnormalities are corrected by a movement which reverses or erases the "strained area."

As seen on the chart, the A-D ratio (representing the advancing or declining tendencies of all NYSE issues)





topped out in 1956. At that time the Dow was in the 520 area. Despite the topping out of breadth, the Dow plowed higher for another ten years, or until 1966. All during this period the market strain was becoming more flagrant as the A-D ratio sank to progressively lower levels.

There is no adequate explanation for the unbelievable ten-year divergence between price and breadth (1956-66), nor is there a perfect explanation for the renewed divergence which occurred between 1970 and 1973. My own thesis is that during the whole period the US Government was engaged in a process of unprecedented manipulation of the economy via massive inflation. This had the strongest effect on the largest or Dow-type companies, while the rest of the market (as represented by the A-D ratio) was beset by increasing problems, problems which somewhat offset the upward push of inflation.

At any rate, 1966 was the year that marked the start of the bear market as the Dow got in gear with the A-D ratio. This first leg of the bear market saw the Dow sink to the 744.32 level. A recovery into 1968 ensued, followed by a second bear market smash. This time the Dow dropped to 631.16 (1970). Finally, under the impetus of an all-out inflationary policy on the part of the Fed, the Dow stilted up to a record 1973 peak of 1051.70. The A-D ratio continued to diverge. In the face of the renewed technical deterioration, the Dow plunged into the 1973-74 phase of the bear market. In December of 1974 the Dow halted at 577.66. The mass of stocks were horribly battered, many having lost up to 90% of their value. The bear market was, by any reckoning, was the worst since the 1930's.

Two factors strike me as most interesting as I currently study the chart picture. First, the Dow, in December, 1974, had come back to within 57 points of its 1956 high. And it was in 1956 that the great price-breadth divergence began. In coming down to the 1956 level, the market had wiped out literally all the upside progress since the great divergence between price and breadth began in 1956.

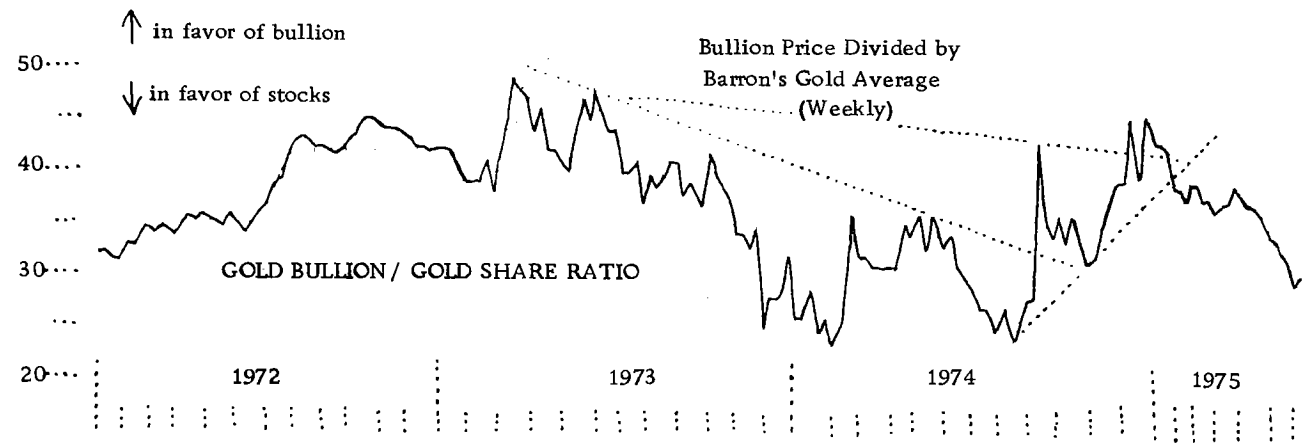
The second factor is that the A-D ratio at the 1974 low had come all the way back to the level of the base which was formed in the 1930's and '40's. This would seem to be almost beyond coincidence. In coming down to the 1930's-1940's base, it would also seem that the market had discounted all the bearish possibilities short of a fall of the West. These two factors were instrumental in turning me bullish in late-1974, although I have never mentioned the first consideration in these Letters before.

Conclusion: This chart provides dramatic evidence of the depth and extent of the 1966-74 bear market. In terms of intensity of correction and damage done, it has few equals in history. My own feeling is that the tide turned bullish in October, 1974, and that regardless of shocks or difficult times ahead, the lows of 1974 will hold during the year or so ahead, and perhaps for many years ahead. The worst, in my opinion, was almost surely discounted by the market in the final collapse of stocks during 1974.

GOLD: I had a long talk with Jim Dines yesterday, and in the course of the conversation Jim said that he wondered why in this huge investment business involving so many billions of dollars and millions of people, there are so few of us writing market letters. "It's not that there are so few of us, James," I said, "it's that it's such a tough business. There have been a lot of market writers. But only a few of us seem to survive."

The chart below is just another example of why the investment field is such a devil. Here we see what is actually a relative strength chart comparing gold bullion and gold shares. As you can see, from 1972 to early 1973 there was a preference for the bullion over the shares, and the ratio line rose. Then during most of 1973 to mid-1974 there was a trend toward stock preference. In September and October, 1974 the gold shares collapsed while bullion held relatively well, and the index rose sharply. That rise in the ratio towards bullion preference lasted until January of this year.

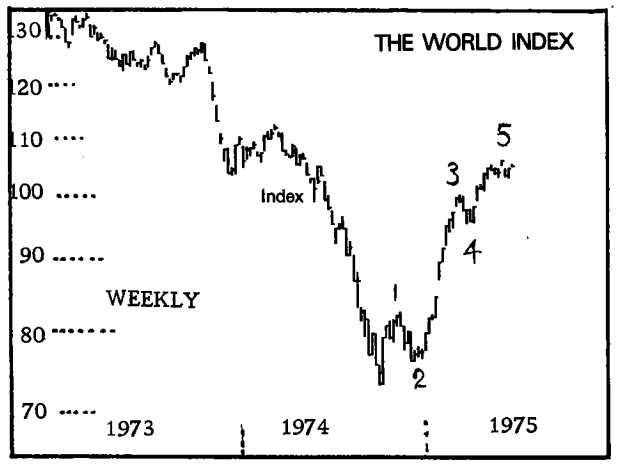
Now, note what has occurred since January. There has been a steady drop in the ratio towards preference for the shares. What has actually occurred is that bullion has slid steadily from its 190's price of January, 1975 to its current price in the mid-160's. During the same period gold share prices have tended to rise, and in the case of the listed shares the rise has been considerable.



What's next? The ratio is now moving down towards its area of bottoms (or at least towards the area of its 1973 and 1974 bottoms). It should halt there. That means to me that gold bullion is either going to rise in price (which would justify the superior gold share performance. Or the gold shares are going to come down in price (which would put them more in line with bullion). In other words, I am saying that the ratio line is not going to come down much further, and gold and gold shares are not going to get much further out of gear. Either bullion will rally or the shares will decline. At this point, I would have to bet on the shares coming down a bit.

On Monday, July 14, the second London fix was 166.75. Bullion may be getting in line for a push up to the mid-170's level. If it hits 175, we will see how much power is behind the metal. A price of 175 would represent a full reversal of the big move down from last year's record high of 1975. My bullion momentum index hit bottom a month ago, but so far the upside momentum has been slow to arrive.

WORLD: This is the World Index, computed by Capital International Perspective (15, rue du Cendrier, CH 1201, Geneva, Switzerland). It is composed of the stock averages of major European and Asiatic markets plus the US market. I have shown this index before, and I want to update it.



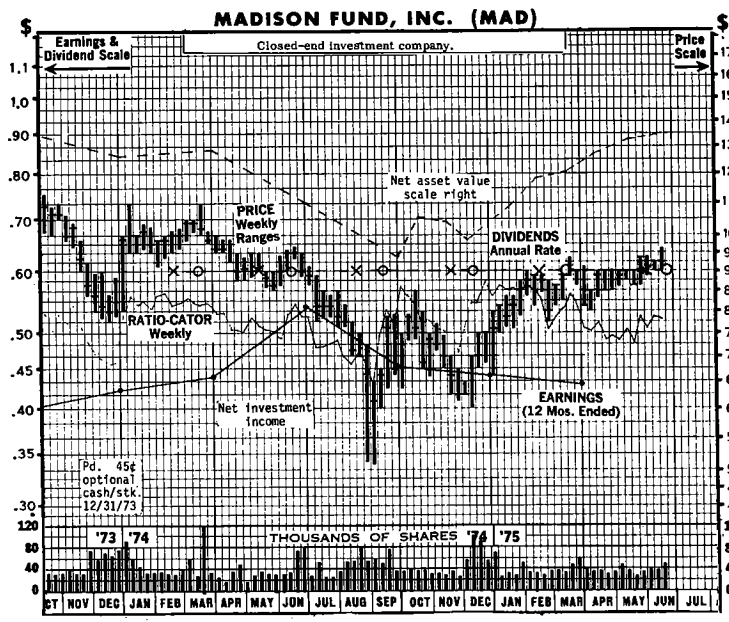
Following the 1973-74 world crash, the World Index bottomed out in October, 1974, then proceeded to trace out a five-leg advance (as shown). This is of interest to Elliott wave students. Elliott corrections take the form of three-leg advances, but now we have a five-leg advance. This implies that we have seen the first leg of a bull movement and that the upward progress (despite any impending correction) will continue.

If the rise since October had produced only an A-B-C, we could worry that any downturn might be the potential first leg of a continuation of the bear market. But the five-leg structure since October, 1974 is bullish. It is not the kind of structure that develops into a collapse to new lows. Five-leg upward structures seldom precede that kind of action, but they are usually followed by secondary corrections. We may be near that point now (and many major stock indices in the Free World are moving into a corrective phase).

STOCKS: This market's no "cup of tea" anymore, and a lot of the stocks have been fairly well combed over. But it's still a bull market, and despite lack of Transport confirmation it keeps huffing and puffing up.

I've been looking over some of the closed-end funds, and the percentages are interesting. For instance, ASA is now selling at a premium of 45.5%, which is much too much in my opinion, and the preferred action would be to hold the actual S. African shares rather than this ballooned issue (James Dine, please don't read this paragraph).

Next, I note that Tri-Continental, which I have liked and recommended repeatedly, is pushing its high for the year at 21-7/8. That's up 20% from the original recommendation, but TY is still a very legitimate way to be in this bull market.


MADISON FUND, INC. (MAD)
Closed-end investment company.
Earnings & Dividend Scale
Price Scale
Net asset value scale right
PRICE Weekly Ranges
DIVIDENDS Annual Rate
RATIO-CATOR Weekly
Net investment income
EARNINGS (12 Mos. Ended)
Pd. 45¢ optional cash/stk. 12/31/73
'73
'74
'75
THOUSANDS OF SHARES
OCT NOV DEC JAN FEB MAR APR MAY JUN JUL AUG SEP OCT NOV DEC JAN FEB MAR APR MAY JUN JUL

Now here is another interesting closed-end fund. Madison Fund is currently selling at 30.9% below asset value, which currently stands at $14.66 per share. Madison's portfolio is particularly interesting. Over 20% of Madison't holdings are in oil and natural gas. In addition, 10% of Madison't holdings are in oil well service companies. Also, 10% of the fund's assets are in mining and metals. That means that this fund has over 40% of its holdings in natural resource stocks, and in effect the fund is a play on the natural resources of the nation. As they used to say in my home town of NYC, "Is that bad?" And the answer is that it's not bad at all. Consequently, I will state that Madison Fund is a good hedge on our vanishing natural resources with the kicker of selling at almost one-third under its actual asset value. Madison pays 15¢ per quarter, yields around 6%, and also can pay out extra from capital gains if it wishes. (Chart courtesy of Security Research, 208 Newbury St., Boston, MA 02116).

LATE NOTES: Transports are turning sloppy again, but as long as they hold above the last low of 169.21 (July 7) I'll give them the benefit of the doubt. I think they want to go through upside..... Next mailing date for DTL: July 25.